

1 **CALIFORNIA STATE BOARD OF EQUALIZATION**

2 **SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40**

3 In the Matter of the Consolidated Petitions for)
4 Reassessment of the 2013 Unitary Values for:)

5 **GWF ENERGY LLC – HANFORD (1122)**)

Appeal No.: SAU 13-029
Case ID No.: 743424

7 **GWF ENERGY LLC – HENRIETTA (1123)**)

Appeal No.: SAU 13-030
Case ID No.: 743425

9 **GWF ENERGY LLC – TRACY (1124)**)

Appeal No.: SAU 13-031
Case ID No.: 743427

10 Petitioners)

11 Oral Hearing Date: December 17, 2013

12
13 **Representing the Parties:**

14 For the Petitioners:

Paul Bellon, Director
Duff & Phelps

16 For the Respondent:

Susan Galbraith, Tax Counsel
Attorney for State-Assessed Properties Division

18 Kurt A. Beck, Senior Specialist Property Auditor Appraiser
19 State-Assessed Properties Division

20 Counsel for Appeals Division:

Dana R. Brown, Tax Counsel III (Specialist)

22 **PROPOSED VALUES**

24 **GWF Energy LLC - Hanford (1122)**

	Value	Penalty	Total
25 2013 Board-Adopted Unitary Value	\$41,100,000	\$0	\$41,100,000
26 Petitioner's Requested Unitary Value	\$13,000,000	\$0	\$13,000,000
27 Respondent's Appeal Recommendation	\$41,100,000	\$0	\$41,100,000

1 GWF Energy LLC - Henrietta (1123)

	Value	Penalty	Total
2 2013 Board-Adopted Unitary Value	\$35,800,000	\$0	\$35,800,000
3 Petitioner's Requested Unitary Value	\$16,500,000	\$0	\$16,500,000
4 Respondent's Appeal Recommendation	\$35,800,000	\$0	\$35,800,000

5 GWF Energy LLC – Tracy (1124)

	Value	Penalty	Total
6 2013 Board-Adopted Unitary Value	\$266,400,000	\$0	\$266,400,000
7 Petitioner's Requested Unitary Value	\$196,500,000	\$0	\$196,500,000
8 Respondent's Appeal Recommendation	\$266,400,000	\$0	\$266,400,000

9 LEGAL ISSUE

10 Whether petitioners have shown that the 2013 Board-adopted unitary value erroneously
11 includes the nontaxable intangible value attributable to their power purchase agreements as established
12 by a purchase price allocation.

13 FINDINGS OF FACT AND RELATED CONTENTIONS

14 On December 13, 2012, GWF Energy Holdings LLC acquired petitioners GWF Energy
15 LLC – Hanford (Hanford), GWF Energy LLC – Henrietta (Henrietta), and GWF Energy LLC – Tracy
16 (Tracy) power generation facilities from affiliates of Harbert Power, LLC. The total purchase
17 consideration amounted to \$631 million.

18 Petitioners Hanford and Henrietta both have peaking power¹ facilities located in
19 Kings County. The Hanford facility is located in Hanford, California, and the Henrietta facility is
20 located approximately 20 miles southwest of Hanford, California. The Hanford and Henrietta facilities
21 each consist of two gas turbine generators. Petitioner Tracy's facility is a combined cycle facility
22 located in Tracy in San Joaquin County. The Tracy facility ceased production as a peaking facility in
23 or around October 2010 and also has two gas turbine generators.

24 The 2013 Board-adopted unitary values for the Hanford and Henrietta facilities were
25 determined by placing 60-percent reliance on the Replacement Cost Less Depreciation (ReplCLD)
26 value indicator, and 40-percent reliance on the Capitalized Earning Approach (CEA) value indicator for
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28 ¹ A "peaker" is a facility where the generating equipment is operated during the hours of highest seasonal demand as required or dispatched by the California Independent System Operator.

1 the Hanford and Henrietta facilities. The 2013 Board-adopted unitary value for petitioner Tracy’s
2 facility was determined by placing 100-percent reliance on the ReplCLD value indicator.

3 Petitioners’ appraisal report prepared by Duff & Phelps (D&P report) in section 5, titled
4 “Valuation of the Intangible Assets,” identifies as intangible assets petitioners’ 10-year “tolling
5 agreements”² with Pacific Gas and Electric Company (PG&E). Under the tolling agreements,
6 petitioners sell electricity to PG&E in return for payments of stated amounts under specified terms.
7 The D&P report included a purchase price allocation which allocated the \$631 million sales price to
8 land, plant and equipment, as well as to the tolling agreements with PG&E. The D&P report relies on
9 *Accounting Standards Codification 805*, which discusses the valuation of identifiable tangible and
10 intangible assets as a result of a purchase, to support the allocation of value to an intangible component
11 such as a tolling agreement. The D&P report determined the fair value of the tolling agreements as
12 follows: Tracy - \$305 million, Hanford - \$35 million and Henrietta - \$35 million.

13 Based on the D&P report, petitioners contend that their power purchase agreements
14 (PPAs) are intangible assets and that the values of those intangible assets are erroneously included in
15 the 2013 Board-adopted unitary values. Petitioners assert that the unitary values should be determined
16 by calculating the value difference between the revenues generated with their PPAs in place and the
17 revenues that would be generated in an “open market” if they did not operate with their PPAs.

18 Petitioners contend that the PPAs are “operating agreements,” which, they allege, are a
19 type of intangible asset that the California Supreme Court in *Elk Hills Power, LLC v. Board of*
20 *Equalization* (2013) 57 Cal.4th 593 (*Elk Hills Power*) held must be identified, valued and removed
21 from the total value of petitioners’ unitary property. Petitioners cite the court’s reasoning that “the
22 value of intangibles that directly enhance the income stream cannot be subsumed in the valuation of
23 taxable property and must be deducted from the unit prior to assessment” as a basis for their position.
24 Petitioners assert that they purchased tangible and intangible assets and that the PPAs were a
25 “significant factor” in the purchase price and represent the majority of the value of the assets acquired
26 in the purchase of the power plant properties.

27 _____
28 ² The tolling agreements are also referred to as power purchase agreements in this summary decision.

1 Petitioners acknowledge that in *Watson Cogeneration Co. v. County of Los Angeles*
2 (2002) 98 Cal.App.4th 1066 (*Watson Cogeneration*), the Court of Appeal held that the assessor
3 properly included the value of a PPA in the calculation of the income approach value indicator for the
4 assessment of a cogeneration power facility. However, petitioners contend that *Watson Cogeneration*
5 was overruled by *Elk Hills Power*, which, they allege, specified all “operating contracts,” unlike ERCs,
6 must be deducted because they make a direct contribution to the going concern value of the business.
7 Petitioners further contend that *Elk Hills Power* affirms the Board’s guidance provided by the
8 Assessors’ Handbook section 502, *Advanced Appraisal* (December 1998) (AH 502).

9 Petitioners posit that a willing buyer of a power plant property will pay more for the
10 intangible right to collect an income stream under a PPA and, thus, the value of the PPA must be
11 excluded. Petitioners further assert that *Elk Hills Power* is merely a clarification of existing law and,
12 therefore, that *Freeport-McMoran Resource Partners v. County of Lake* (1993) 12 Cal.App.4th 634
13 (*Freeport-McMoran*) and *Watson Cogeneration* are no longer controlling precedent.

14 Respondent contends that the 60-percent reliance on the ReplCLD value indicator and
15 40-percent reliance on the CEA value indicator is consistent with the methodology used to value other
16 peaking facilities similarly situated to the Hanford and Henrietta facilities. Respondent also contends
17 that 100-percent reliance on the ReplCLD value indicator is consistent with the methodology used for
18 combined cycle facilities similarly situated to the Tracy facility. Respondent states that its ReplCLD
19 indicator is based on a cost-per-megawatt factor, after updating the cost-per-megawatt based on
20 industry specific information from sources such as Gas Turbine World and the Bureau of Labor
21 Statistics. Respondent asserts that industry representatives and respondent believe these sources are
22 conservative in calculating cost-per-megawatt as they include only the actual cost of purchasing the
23 turbines and related facility equipment.

24 After adjusting for physical obsolescence and using respondent’s value for assessable
25 land, the Board-adopted unitary values were calculated by placing reliance on ReplCLD value
26 indicators, weighted at 60 percent, for petitioners’ Hanford and Henrietta facilities as follows:
27 \$45,221,169 (approximately \$492,000 per megawatt) for the Hanford facility and \$35,760,737
28 (approximately \$365,000 per megawatt) for the Henrietta facility. The Board-adopted unitary values

1 were calculated by placing reliance on CEA value indicators, weighted at 40 percent, for petitioners’
2 Hanford and Henrietta facilities from projected generation revenue, fuel costs, and operating expenses
3 petitioners provided as follows: \$34,997,809 for the Hanford facility and \$35,805,115 for the Henrietta
4 facility. The Board-adopted unitary value for the Tracy facility was calculated by placing 100-percent
5 reliance on the ReplCLD value indicator for a value of \$266,400,000 (approximately \$800,000 per
6 megawatt).

7 Respondent states that petitioners attribute an intangible component to the PPAs by
8 calculating the value difference between having a PPA in place and the revenues that might be
9 generated in a hypothetical “open market” scenario where PPAs do not exist, using a discounted cash
10 flow (DCF) model.³ Respondent asserts that petitioners compare their revenues with revenues from
11 facilities operating in an “open market” even though petitioners’ facilities were not built with the
12 expectation of operating without PPAs. According to respondent, this reasoning mistakenly assumes
13 that revenues under the PPAs are not market revenues. Respondent contends that a PPA between a
14 power generating facility and a utility company is common and that most facilities enter into
15 10-to-15-year contracts, with the duration depending on such factors as location and system needs prior
16 to being constructed. Respondent asserts that PPAs provide a predictable, reliable and stable cash flow
17 for the contract term. Moreover, respondent contends that petitioners operate in a market where most
18 new power plants contract with a utility to provide power generation for a number of years, and thus
19 the market on which a comparison of value must be made is reflected in the contract terms. Thus,
20 respondent concludes that petitioners’ PPAs with PG&E to provide electricity on terms different than
21 those available without such an agreement does not necessarily create a nontaxable intangible asset and
22 states that petitioners have cited no statutory, regulatory or judicial authority for this premise.

23 Respondent contends that *Freeport-McMoran* is controlling precedent and, based on that
24 decision, respondent correctly used the revenue generated from the PPAs to calculate the income
25 approach indicators for petitioners’ plants. Respondent states that *Freeport-McMoran* properly
26 interpreted Revenue and Taxation Code (R&TC) section 110, subdivision (e) by holding that a PPA is
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28 ³ A DCF model is an income approach valuation method.

1 the means by which a power plant sells electricity and that income generated by that PPA “is
2 inextricably tied to the beneficial use of the property and properly considered in assessing its value.”
3 Respondent further argues that the court in *Watson Cogeneration* followed the *Freeport-McMoran*
4 court’s reasoning by holding that the highest and best use of the subject property was a power plant
5 with PPAs in place. In this regard, the court held that, when the income stream is expected to remain
6 stable, the assessor should use actual income from the PPAs rather than imputed income. On that basis,
7 respondent contends that the proper market for comparison with petitioners’ properties is power plants
8 with PPAs.

9 Respondent also contends that the holding in *Elk Hills Power* is consistent with
10 *Freeport-McMoran* and *Watson Cogeneration* and, therefore, supports respondent’s valuation
11 approach. Respondent explains that in *Elk Hills Power* the court held that a deduction from the income
12 stream for an intangible asset is appropriate only if a separate stream or an enhanced stream of income
13 attributable to the enterprise activity is created. However, according to respondent, in this case there
14 was no separate or enhanced stream of income because the PPAs are necessary to the beneficial use of
15 the property and the market that must be used to determine whether an enhanced income stream exists
16 is the market of similarly situated power plants. With respect to the *Elk Hills Power* decision,
17 respondent asserts that the court held the Board may not add any value in its replacement cost method
18 for emission reduction credits (ERCs); but, if no value was added, then no value need be deducted
19 because such a deduction from value would result in a “windfall.” Respondent contends that the
20 *Elk Hills Power* court’s holding is completely contrary to the position taken by petitioners in this
21 appeal.

22 Respondent asserts that the D&P report is problematic because there was no cost
23 approach indicator calculated despite the fact that hundreds of millions of dollars were spent
24 reconfiguring the Tracy facility after securing the PPA for that facility. Respondent further asserts that
25 the calculation of a cost approach indicator would have demonstrated that the cost of acquiring the PPA
26 was not consistent with the purchase price allocation adjustment. Respondent contends that the market
27 for electricity in California is controlled by the California Public Utilities Commission (CPUC), the
28 Independent System Operator (ISO) and the California Energy Commission (CEC), which set

1 requirements, including the procurement of a PPA, prior to the construction of a power plant. For that
2 reason, respondent asserts it is correct to value the properties by assuming that PPAs were in place in
3 accordance with R&TC section 110, subdivision (e).

4 Respondent contends that any intangible value attributable to the PPAs would only be
5 reflected if petitioners negotiated favorable, above-market rates for the sale of electricity in the PPAs,
6 but, under such circumstances, only the above-market portion of the rates would be deducted.
7 However, respondent further contends that these PPAs are contracts required by the regulating agencies
8 to ensure “resource adequacy” to provide sufficient electricity to California customers. Therefore,
9 respondent concludes that the rates negotiated by the parties in the PPAs are not above-market rates.

10 Respondent contends petitioners anticipated the acquisition of the PPAs and the income
11 generated by them when they purchased the properties so that respondent’s position is consistent with
12 Property Tax Rule 8, subdivision (c).⁴ Furthermore, respondent contends the existence of PPAs reflect
13 the electricity market and respondent’s ReplCLD indicator did not add any value for the PPAs.

14 Respondent contends that petitioners’ arguments, which assume that one can value a plant based on
15 electricity sales in the spot market, disregard the configuration of electricity markets in California.

16 Respondent observes that the Tracy property is a state-of-the-art facility and that
17 respondent has information from 40 other plants in California to make the necessary adjustments to the
18 ReplCLD value indicator for this facility. Respondent maintains that Property Tax Rule 6 provides that
19 the cost approach is appropriate for newly constructed property, such as the Tracy facility, and
20 respondent has data for that plant as well as other plants in California to determine replacement cost
21 after a contract has been procured. Respondent states that the purchase price was well in excess of
22 replacement cost due to business value and some value to the PPA, but not to the extent proposed by
23 the purchase price allocation, which is confirmed by other purchase price allocations that have not
24 valued PPAs in this manner. Respondent further argues that: (1) petitioners failed to identify any
25 economic obsolescence that would invalidate the use of the cost approach indicator and have made no
26 attempt to show that the PPAs are favorable (i.e., reflect above-market rates); (2) adjustments in the
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⁴ All references to Property Tax Rules are to sections of title 18 of the California Code of Regulations.

1 PPAs ensure that the rates reflect market pricing, particularly adjustments for the price of natural gas;
2 and (3) under R&TC section 110, respondent is required to estimate cost of replacement assuming the
3 existence of a PPA.

4 In addition, respondent asserts that the Tracy facility was, for the most part, converted to
5 a more efficient combined cycle plant after the PPA was procured, which makes it clear that this plant
6 must be valued assuming the PPA was in place under R&TC section 110, subdivision (e). With respect
7 to economic obsolescence, respondent contends that no power plant operates at 100-percent utilization
8 due to varying demands for electricity.

9 In their reply, petitioners dispute use of respondent's ReplCLD indicator for the Tracy
10 facility because it is higher than petitioners' opinion of value for that facility. Petitioners maintain that,
11 based on the open market sales information, the D&P report determined that the value of the tangible
12 property was less than the ReplCLD indicator, which is evidence that respondent did not make a full
13 adjustment for the value of the intangibles which in turn resulted in the overvaluation of petitioners'
14 unitary properties. Petitioners further contend that a cost approach indicator must include an adjustment
15 for all forms of obsolescence, including economic obsolescence, but that respondent failed to consider
16 petitioners' forward-looking projections that did not contemplate 100-percent utilization. Petitioners
17 assert that there is a basis for making an adjustment that would bring respondent's cost approach
18 indicators in line with the D&P report values.

19 Petitioners contend that respondent failed to make obsolescence adjustments for the
20 Tracy facility because it was a new plant without an earnings history. Petitioners further assert that
21 respondent in its valuation analysis recognized "implicit value" in the PPAs as evidenced by variation
22 in the three value indicators, particularly respondent's comparable sales value indicator of \$550 million
23 and ReplCLD value indicator of \$266 million.

24 APPLICABLE LAW AND APPRAISAL PRINCIPLES

25 Reconciliation of Value Indicators

26 Property Tax Rule 3 requires that, in estimating value, the assessor shall consider one or
27 more of the approaches to value "as may be appropriate for the property being appraised," which
28 include the comparative sales approach, the replacement or reproduction cost approach (e.g., ReplCLD

1 valuation methodology) or the income approach. The appropriateness of an approach is often related to
2 the type of property being appraised and the available data. (AH 502, p. 109.) If a large amount of
3 comparable data is available for a given approach, the appraiser may have more confidence in that
4 approach. For example, if income, expense and capitalization rate data can be obtained from many
5 properties comparable to the subject property, the appraiser may attribute significant accuracy to the
6 income approach. The greatest reliance should be placed on the approach or combination of
7 approaches that best measures the type of benefits the subject property yields. The final value estimate
8 reflects the relative weight that the appraiser assigned, either implicitly or explicitly, to each approach.
9 (AH 502, p. 112.)

10 ReplCLD Value Indicator

11 Property Tax Rule 6, subdivision (a) provides, in part: “The reproduction or
12 replacement cost approach to value . . . is preferred when neither reliable sales data . . . nor reliable
13 income data are available . . .” In general, the ReplCLD valuation methodology is estimated by
14 applying trend factors—price level changes, including the application of “current prices to the labor and
15 material components of a substitute property capable of yielding the same services and amenities, with
16 appropriate additions as specified . . .” (Property Tax Rule 6, subd. (d).) The resulting adjusted
17 replacement cost amount is “reduced by the amount that such cost is estimated to exceed the current
18 value of the reproducible property by reason of physical deterioration, misplacement, over- or
19 underimprovement, and other forms of depreciation or obsolescence. The percentage that the
20 remainder represents of the reproduction or replacement cost is the property’s percent good.” (Property
21 Tax Rule 6, subd. (e).)

22 Income Approach to Value

23 Property Tax Rule 8, subdivision (a) states that “[t]he income approach to value is used
24 in conjunction with other approaches when the property under appraisal is typically purchased in
25 anticipation of a money income and either has an established income stream or can be attributed a real
26 or hypothetical income stream by comparison with other properties.” Subdivision (b) describes the
27 income approach to value as the valuation method whereby “an appraiser values an income property by
28 computing the present worth of a future income stream. This present worth depends upon the size,

1 shape, and duration of the estimated stream and upon the capitalization rate at which future income is
2 discounted to its present worth.” Subdivision (c) provides that “[t]he amount to be capitalized is the net
3 return which a reasonably well informed owner and reasonably well informed buyers may anticipate on
4 the valuation date that the taxable property existing on that date will yield under prudent management
5 and subject to legally enforceable restrictions as such persons may foresee as of that date.” Rule 8,
6 subdivision (e) provides, in relevant part, that income projections may be used if recent income is
7 “reasonably indicative of the income the property will produce in its highest and best use under prudent
8 management.” Subdivision (e) further provides that, “[w]hen income from operating a property is
9 used, sufficient income shall be excluded to provide a return on working capital and other nontaxable
10 operating assets and to compensate unpaid or underpaid management.”

11 Revenue and Taxation Code section 110

12 R&TC section 110, subdivisions (a) and (b) define “full cash value” or “fair market
13 value” for California property tax assessment purposes. Subdivisions (d) and (e) set forth the
14 limitations on taxation of intangible value and provide, in part, that:

15 (d) Except as provided in subdivision (e), for purposes of determining the “full cash
16 value” or “fair market value” of any taxable property, all of the following shall apply:
17 (1) The value of intangible assets and rights relating to the going concern value of a
18 business using taxable property shall not enhance or be reflected in the value of the
19 taxable property.

20 (2) If the principle of unit valuation is used to value properties that are operated as a unit
21 and the unit includes intangible assets and rights, then the fair market value of the taxable
22 property contained within the unit shall be determined by removing from the value of the
23 unit the fair market value of the intangible assets and rights contained within the unit.

24 [¶] . . . [¶]

25 (e) Taxable property may be assessed and valued by assuming the presence of intangible
26 assets or rights necessary to put the taxable property to beneficial or productive use.

27 Freeport-McMoran

28 The Court of Appeal in *Freeport-McMoran* examined whether intangible value may be
properly assigned to a PPA known as a standard offer contract (SO4 contract) in determining a power
plant’s unitary value. In *Freeport-McMoran*, the taxpayer owned geothermal power plants and argued
that the county assessor overvalued its property by basing the property tax assessment on capitalization

1 of the income derived from PPAs with a public utility at above market rates. The court found that the
2 evidence showed that the power plant would only be offered for sale in conjunction with the SO4
3 contract because “the contract is integral to the economic viability of the plant” and “a prospective
4 purchaser would be willing to pay more for a plant with an SO4 contract than for a plant without one
5 because the SO4 contract guarantees a higher income.” (*Freeport-McMoran, supra*, at p. 644.) Thus,
6 the court held that the proper market for valuation of the taxpayer’s power plants was a market
7 consisting of existing facilities with similar power purchase agreements. (*Id.* at p. 645.)

8 The court also rejected the taxpayer’s argument that the income generated from the
9 taxpayer’s PPAs was nontaxable intangible property. The court followed the decision in
10 *County of Stanislaus v. Assessment Appeals Bd.* (1989) 213 Cal.App.3d 1445 (*County of Stanislaus*),
11 which involved taxation of a cable television franchise consisting of the right to use public streets for
12 cables and the right to charge fees to subscribers for use of the cable facilities. In *County of Stanislaus*,
13 the court held that the latter component, the intangible right to do business, was necessary to put the
14 possessory interest to its beneficial or productive use and, therefore, should be considered in valuing
15 the possessory interest. By the same reasoning, the *Freeport-McMoran* court concluded that the SO4
16 contracts were not nontaxable intangibles because they were the means “by which appellant’s
17 properties are put to beneficial use and must be considered in assessing the properties’ ‘full value.’”
18 (*Freeport-McMoran, supra*, at pp. 645-646.)

19 Finally, the court rejected the taxpayer’s argument that consideration of the value of the
20 SO4 contract “improperly taxes appellant’s enterprise activity or business skill.” (*Freeport-McMoran,*
21 *supra*, at p. 646.) The court acknowledged that under the income approach indicator of value “income
22 derived in large part from enterprise activity may not be ascribed to the property.” (*Ibid.*) However,
23 the court held that the SO4 contract was the means by which the taxpayer sold its electricity and,
24 therefore, “the income generated by the SO4 contract is inextricably tied to the beneficial use of the
25 property and [is] properly considered in assessing its value.” (*Ibid.*) The court further found that there
26 was no evidence the increased value of the SO4 contract over a market rate was due to appellant’s
27 enterprise activity. (*Ibid.*) Thus, the court concluded that the higher price received under the SO4
28 contract was not “the result of appellant’s successful operation of its plants but of the regulatory

1 scheme that allowed appellant the benefit of a long-term fixed contract price.” (*Ibid.*)

2 Watson Cogeneration

3 The Court of Appeal in *Watson Cogeneration* held that the assessor properly included
4 the value of a PPA in the calculation of the income approach value indicator for the assessment of a
5 cogeneration power facility. In that case, the taxpayer owned and operated a cogeneration power
6 facility which was developed as a “qualifying facility” under federal law. Under federal regulations,
7 utility companies were required to purchase electricity from qualifying facilities at the utility’s
8 “avoided cost” and, to assist in implementation of this federal requirement, the CPUC approved a series
9 of “standard offer contracts” for the purchase of power from qualifying facilities. A qualifying facility
10 that met the terms of a standard offer contract was assured of selling its output to a public utility.
11 (*Watson Cogeneration, supra*, at p.1068.)

12 The taxpayer entered into a 20-year standard offer contract with a public utility that, as
13 of the valuation date, provided for above-market prices for its electricity output. The taxpayer
14 contended that the assessor should not have included the full value of its standard offer contract
15 because that favorable contract was an intangible asset exempt from property taxation. The taxpayer
16 framed the issue as whether the assessor could assess its property based upon income that the taxpayer
17 received by operating the plant under an “above-market” contract with the public utility.
18 (*Watson Cogeneration, supra*, at p. 1069.)

19 The court found that the highest and best use of the property was as a qualifying facility
20 selling electricity under the standard offer contract, which guaranteed the sale of its output at an
21 above-market price. (*Watson Cogeneration, supra*, at pp. 1071-1072.) Thus, the court concluded, in
22 accordance with prior case law, that the value of the taxpayer’s property was best estimated by using
23 the actual income under the standard offer contract rather than imputed income. (*Id.* at p. 1072.) The
24 court also noted that, as of the valuation date, the taxpayer’s own expert witness testified that the plant
25 would not have operated as profitably without the standard offer contract; and, on that basis, the court
26 concluded that the evidence showed that the highest and best use of the property was as a qualifying
27 facility with a power purchase agreement. (*Id.* at p. 1074.) Thus, the court held that the reasoning of
28 *Freeport-McMoran* was still applicable and that the assessor properly assumed the presence of the

1 standard offer contract in the valuation of the taxpayer’s cogeneration power facility. (*Ibid.*)

2 The court distinguished cases in which the courts held that an assessor is required to
3 segregate and exclude intangible rights and assets, such as franchise rights, concession rights, cable
4 licenses, liquor licenses and other assets attributable to the enterprise value of the business.
5 (*Watson Cogeneration, supra*, at pp. 1075-1076.) The court stated that the power generation facilities
6 in *Freeport-McMoran* and in *Watson Cogeneration* were a different type of business and the PPAs
7 were a different type of intangible than in those other cases. (*Id.* at p. 1075.) In that regard, the court
8 noted that the power generation projects were “the result of government incentives and regulations
9 specifically intended to encourage their development,” such as the PPAs, which were “inextricably
10 intertwined with the creation and operation of the project as a qualified facility.” (*Ibid.*) Therefore, the
11 court held that as long as the property operated as a qualifying facility and received the predictable
12 income stream under the standard offer contract, the assessor appropriately valued the property based
13 on its actual income. (*Id.* at p. 1075.)

14 *Elk Hills Power*

15 In *Elk Hills Power*, the California Supreme Court addressed the question of how to
16 properly value, for property tax purposes, a power plant whose construction and operation had required
17 the owner to acquire and apply certain ERCs, which were undisputed to be intangible assets that
18 provided legal rights that were necessary for the beneficial and productive use of the power plant.
19 (*Elk Hills, supra*, 57 Cal.4th at p. 619.)

20 Primarily at issue in *Elk Hills Power* was the interpretation of RT&C section 110,
21 subdivisions (d) and (e) and RT&C section 212, subdivision (c). The court explained:

22 Sections 212(c) and 110(d) prohibit the direct taxation of certain intangible assets and
23 rights, including the ERCs in this case. However, in assessing taxable property under
24 section 110(e), the Board may “assum[e] the presence of intangible assets or rights
25 necessary to put the taxable property to beneficial or productive use.” The key issue is
whether section 110, subdivisions (d) and (e) are mutually exclusive provisions, as the
Court of Appeal held, or whether they can be applied together. We conclude that
subdivisions (d) and (e) can be applied together.

26 (*Elk Hills Power, supra*, 57 Cal.4th at p. 602.)
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28

1 The court further explained:

2 Section 110(d)(1) prevents *the value* of intangible assets from enhancing or being
3 reflected in the valuation of taxable property. Section 110(e) allows assessors to enhance
4 the valuation of taxable property, not by including *the value* of intangible assets in the
5 valuation (see § 110(d)(1)), but simply by *assuming the presence* of intangible assets
6 when valuing the taxable property put to beneficial or productive use. While the value of
7 the taxable property is enhanced, it is not enhanced by *the value* of intangible assets.
8 That would violate section 110(d)(1) as well as section 212(c). Rather, it is enhanced by
9 *the presence* of intangible assets.

10 (*Elk Hills Power, supra*, 57 Cal.4th at p. 615, original italics.)

11 Based on this reasoning, the court held that that “the Board directly and improperly
12 taxed the plaintiff’s ERCs when it added their replacement cost to the power plant’s taxable value.”
13 (*Elk Hills Power, supra*, 57 Cal.4th at p. 602.) However, the Court also made clear that “[w]here the
14 taxpayer does not proffer evidence that the Board included the fair market value of an intangible right
15 or asset in the unit whole, the Board would not have to make a deduction prior to assessment. For
16 example, if the Board does not add the value of ERCs to its replacement cost valuation, it obviously
17 would not have to deduct their value prior to assessment, because that would produce an unwarranted
18 windfall for the taxpayer.” (*Elk Hills Power, supra*, 57 Cal.4th at p. 617, fn. 11.)

19 With respect to the CEA approach, the court concluded that the Board correctly
20 “estimated the amount of income the property is expected to yield over its life and determined the
21 present value of that amount.” (*Elk Hills, supra*, 57 Cal.4th at p. 602.) Specifically, the court held that
22 “the Board was not required to deduct a value attributable to the ERCs under an income approach.”
23 (*Elk Hills, supra*, 57 Cal.4th at p. 602.) The court reasoned that, “under an income stream approach,
24 not all intangible rights have a quantifiable fair market value that must be deducted.” (*Elk Hills, supra*,
25 57 Cal.4th at p. 617.) The court then concluded “[t]here was no credible showing that there is a
26 separate stream of income related to enterprise activity or even a separate stream of income at all that is
27 attributable to the ERCs in this case.” (*Elk Hills Power, supra*, 57 Cal.4th at p. 602.)

28 In reaching this conclusion, the court explained that there are two lines of cases relating
to intangibles where an operating property is being valued by use of the CEA approach. In the first line
of cases, “courts have upheld income-based assessments that properly assumed the presence of
intangible assets necessary to the productive use of taxable property without deducting value for

1 intangible assets.” (*Elk Hills Power, supra*, 57 Cal.4th at p. 618.) In this line of cases, the intangible
2 asset authorizes the construction or use of the operating tangible property, and thus has only an *indirect*
3 contribution to the income produced by the tangible property.

4 In the second line of cases, courts “disapproved assessments that failed to attribute a
5 portion of a business’s income stream to the enterprise activity that was *directly* attributable to the value
6 of intangible assets and deduct that value prior to assessment.” (*Elk Hills Power, supra*, 57 Cal.4th at
7 p. 602, italics added.) The court explained the difference in the two lines of cases as follows:

8 The difference is one of degree; intangible rights like ERCs merely allow for the taxable
9 property to generate income when put to its beneficial or productive use. Thus, their
10 contribution to the income stream is indirect, whereas intangible assets like the goodwill
11 of a business, customer base, and *favorable* franchise terms or operating contracts all
12 make a direct contribution to the going concern value of the business as reflected in an
13 income stream analysis. *Only the latter category of intangible assets and rights has a
14 quantifiable fair market value that must be deducted from an income stream analysis
15 prior to taxation.*

16 (*Elk Hills Power, supra*, 57 Cal.4th at pp. 618-619, italics added.)

17 Thus, the court differentiated between, on the one hand, intangible assets that indirectly
18 enhance the value of tangible property (and the income stream produced by the tangible property) by
19 authorizing the beneficial and productive use of the tangible property (hereafter indirect intangibles),
20 and, on the other hand, intangible business or enterprise assets that directly enhance the business
21 income stream (hereafter direct intangibles). (*Elk Hills Power, supra*, 57 Cal.4th at p. 618.) Therefore,
22 a deduction from the income stream based on the assumption of the presence of indirect intangibles is
23 inappropriate while a deduction from the income stream may be appropriate for direct intangibles if the
24 taxpayer adequately proves that the direct intangibles have created a separate stream of income or have
25 enhanced the income stream.

26 ANALYSIS AND DISPOSITION

27 The issue here is whether petitioners have shown entitlement to deductions from the 2013
28 Board-adopted unitary values based on an allocation of nontaxable intangible value to their PPAs.
Pursuant to *Elk Hills Power*, no deduction from respondent’s cost approach calculation is appropriate since
no cost related to the PPAs was added to the ReplCLD value indicator. Moreover, *Watson Cogeneration*
and *Elk Hills Power* make clear that no deduction from the income approach is warranted in this case.

1 In *Watson Cogeneration* (which followed the court’s reasoning in *Freeport-McMoran*),
2 the court held that the assessor was not required to segregate and exclude the PPAs as intangible rights
3 and assets because they were necessary for the beneficial use of the property. (*Watson Cogeneration*,
4 *supra*, at p. 1073.) In the language of *Elk Hills Power*, the PPA is, therefore, an indirect intangible for
5 which no deduction is necessary because such power plants may not be built without a PPA in place.
6 In that way, the PPA is necessary to the beneficial use of the property in similar fashion to the necessity
7 of ERCs to operate a power plant.

8 However, even if the PPAs were considered to make a direct contribution to the income
9 stream, no deduction would be warranted here. *Elk Hills Power* determined that a deduction is
10 appropriate for intangibles that directly enhance the income stream if the taxpayer adequately proves
11 that such intangibles have created a separate stream of income or an enhanced income stream. Pursuant
12 to Rule 8, subdivisions (c) and (e), such a separate or enhanced stream of income for the PPAs at issue
13 would require a showing of an income stream that is greater than what the property would produce in
14 its highest and best use under prudent management. Here, the PPAs at issue are standard operating
15 contracts that necessarily would be entered into under prudent management and, therefore, no exclusion
16 from the income approach to value is warranted for these PPAs under Rule 8 subdivisions (c) and (e).

17 Petitioners’ principal argument is that their PPAs directly enhance the income stream
18 and therefore fall into the category of intangible assets that must be deducted prior to taxation.
19 Petitioners contend that the purchase price allocation is the only evidence in the record of the
20 “quantifiable fair market value” of the PPAs and, therefore, the values established by the purchase price
21 allocation must be deducted from Board-adopted unitary values. However, petitioners provided no
22 evidence that the PPAs create a separate stream of income or enhance the income stream above that of
23 other similarly situated, prudently managed and operated power plant facilities in California built and
24 operated with a PPA in place. In other words, as in *Watson Cogeneration*, the market that must be used
25 to determine whether the PPAs have enhanced the income stream is the market of other power plants
26 with PPAs in place. However, like the plaintiffs in *Watson Cogeneration* and *Freeport-McMoran*,
27 petitioners’ purchase price allocation erroneously uses a hypothetical “open” market to posit that the
28 value of their PPAs enhance their respective income streams. Therefore, we find that the PPAs in

